

**ALPINE ELECTRONICS OF AMERICA, INC.  
INCOME YEAR ENDED 3/31/89  
SECTION 25137 PETITION MATERIALS  
FEBRUARY 25, 2004**

**Tab A – Waiver of Confidentiality**

**Tab B – Taxpayer's Section 25137 Petition (dated 10/23/01)**

**Tab C – Taxpayer's "Clarifying" Letter (dated 3/22/02)**

**Tab D – FTB's Staff Summary and Recommendation (that  
Petition be denied)**


# EXHIBIT A

Alpine Electronics of America, Inc. - 1988  
2920037035010433

### WAIVER OF CONFIDENTIALITY

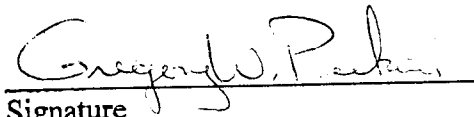
Pursuant to Title 18, California Code of Regulations section 25137(d), petitioner, Alpine Electronics Corporation of America, Inc. (California Corporation Number 0877147) and its subsidiary, Alpine Electronics Manufacturing of America, Inc. (Federal Employer Identification Number 35-1668914) hereby waive the confidentiality provisions of California Revenue and Taxation Code section 190542 with respect to the petition filed under California Revenue and Taxation Code section 25137 for Alpine Electronics Corporation of America, Inc.'s tax year ending March 31, 1989 and with respect to any facts and documents (including those pertaining to other tax years and to affiliated taxpayers) which are considered by the Franchise Tax Board (or its staff) to be relevant to making or defending the determination requested with respect to said petition.

Alpine Electronics Corporation of America, Inc.

By:   
Signature  
HIROSHI NAKANO  
Print Name  
V.P. FINANCE, CONTROLLER  
Title

9-16-03  
Date

Alpine Electronics Manufacturing of America, Inc.

By:   
Signature  
GREGORY W. PERKINS  
Print Name  
Sr. Manager Administration  
Title

9-18-03  
Date

# EXHIBIT B

Alpine Electronics of America, Inc.  
CA ID # 0877147

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## **Petition under CRTC §25137 for Use of an Alternative Method of Apportionment**

### **Name and Principal Address of Taxpayer**

Alpine Electronics of America, Inc.  
19145 Gramercy Place  
Torrance, California 90509

### **Entity Identification Number**

Alpine Electronics, Inc.  
California Corporation number: 0877147

### **Year at Issue**

Income year ended March 31, 1989.

### **Introduction**

The taxpayer, Alpine Electronics of America, Inc. (hereafter referred to as “Alpine” or “the taxpayer”), hereby petitions the Franchise Tax Board (hereinafter referred to as “your Board”) to permit it to use its Japanese parent’s apportionment factors in order to effectuate an equitable allocation and apportionment of its income.

It is Alpine’s position that its Japanese parent’s intercompany profit should be reflected in its opening inventory for the year after a water’s edge election was first made.<sup>1</sup> At a minimum, even if intercompany profit is eliminated and the taxpayer receives no other step up in basis for its opening inventory, Alpine seeks relief pursuant to California Revenue and Taxation Code (“CRTC”) §25137.

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<sup>1</sup> The recent State Board of Equalization case of Yamaha Motors involved an identical issue and specifically addressed whether the seller’s cost or the buyer’s cost should be utilized in calculating the net income of a water’s edge group upon the sale of inventory. The SBE ruled in the taxpayer’s favor finding that there was no authority for the position that the profit in opening inventory should be eliminated in the year following a water’s edge election. As you are aware, the SBE granted the Franchise Tax Board’s (hereinafter referred to as “your Board”) petition for redetermination and withdrew its initial ruling. The case is currently pending.

Alpine Electronics of America, Inc.  
CA ID # 0877147

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CRTC §25137 states:

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) Separate accounting;
- (b) The exclusion of any one or more of the factors;
- (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

If Alpine's beginning inventory that had been purchased from its Japanese parent receives no step-up in basis, the exclusion of the Japanese parent's apportionment factors would create gross distortion in the taxpayer's taxable income. Consequently, if Alpine is required to eliminate the intercompany profit reflected in its inventory and receives no other step up in basis, Alpine seeks relief from the resulting gross distortion.

### **Statement of Facts**

Alpine purchased inventory from its Japanese parent company, Alpine Electronics, Inc. of Japan ("AEJ"). Alpine recorded the inventory it purchased from AEJ at its cost.. Your Board's staff has adjusted Alpine's opening inventory and eliminated AEJ's profit on the sale of the inventory from Alpine's cost, increasing Alpine's gain on the sale of such inventory to reflect AEJ's profit. For its taxable year ended March 31, 1989, Alpine filed a water's edge election and computed its income and apportionment factors on the basis of that election as required by CRTC §25110. Accordingly, it did not include the apportionment factors of AEJ since AEJ was outside of the water's edge group.

Nevertheless, CRTC §25110 provides that only the income and factors of the members included in the water's edge return are to be taken into account. Accordingly, unless relief is granted, AEJ's apportionment factors are not used in determining Alpine's taxable income although AEJ's profit on its sale of inventory to Alpine is included.

Alpine Electronics of America, Inc.  
CA ID # 0877147

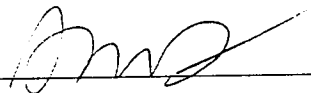
Page 3

**Conclusion**

If Alpine's opening inventory is adjusted to reflect AEJ's carryover basis, Alpine will be forced to reflect in its post water's edge taxable income AEJ's profit on such inventory. In that case, exclusion of AEJ's apportionment factors results in gross distortion. Accordingly, pursuant to CRTC §25137, Alpine respectfully requests that your Board allow it to disregard the statutory requirements with respect to exclusion of AEJ's worldwide affiliates apportionment factors and include them in the computation of California taxable income attributable to such income. Only then will Alpine's activities within and without California be properly reflected in its California apportionment factor.

Dated October 23, 2001

Respectfully Submitted,

By 

Steven M. Danowitz  
Partner  
Ernst & Young LLP  
Authorized Representative of  
Alpine Electronics of America, Inc.  
(310) 551-5599

# EXHIBIT C



*Via Express Mail*

March 22, 2002

Mr. Jeffrey I. Margolis  
Tax Counsel  
Franchise Tax Board  
Legal Branch  
PO Box 1720  
Rancho Cordova, CA 95741-1720

Alpine Electronics of America  
Tax Year Ending 3/31/89  
25137 Petition

Dear Mr. Margolis:

This letter is submitted in response to your request for information regarding Alpine Electronics of America's ("Alpine's") request for relief pursuant to Cal. Rev. and Tax. Code §25137.

In *Appeal of Yamaha Motor Corporation*, which dealt with the identical issue as the instant case, the State Board of Equalization adopted the Franchise Tax Board's Notice 89-601, providing that previously unrecognized intercompany gains should be apportioned to California using the apportionment factors for the year prior to the water's edge election. The income is then included in income over a five year period beginning with the year of the water's edge election.

**Clarification of Request**

At the time that our protective request for 25137 relief was drafted, the *Yamaha* briefs were in the process of being filed with the Board of Equalization (BOE). One of the Franchise Tax Board's arguments in one of its briefs was that *Yamaha* was in the wrong forum and had failed to exhaust its administrative remedies due to its failure to request an alternative apportionment method under section 25137. Our original protective petition was drafted to take into account several of the arguments that were pending before the BOE at the time. Subsequent to our drafting the protective petition, the BOE's views came clear with respect to this matter. Consequently, in hindsight, our protective petition appears to have been overly broad. In light of

Mr. Jeffrey I. Margolis

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the State Board of Equalization's ultimate holding in *Yamaha*, we are requesting that relief be granted pursuant to FTB Notice 89-601. As noted by the BOE staff in the *Yamaha* case, the Franchise Tax Board's proposal to utilize the water's edge group's apportionment factors to determine the amount of the intercompany gain did not clearly reflect income (and was therefore "distortive".) In fact, the State Board staff indicated in the *Yamaha* case that utilizing the water's edge group apportionment factors for intercompany transactions occurring within the worldwide combined report group, a group which consisted of different members and different apportionment factors, appeared inconsistent. Accordingly, in order to clearly reflect income and avoid distortion, it is clear that the appropriate factor relief in our case is to apportion the previously unrecognized intercompany gains using the apportionment factors for the year prior to the water's edge election, or fiscal year ended March 31, 1988 under the methodology set forth in Notice 89-601.

In your letter dated February 14, 2002, you requested certain information with respect to the factor relief that Alpine is requesting. In light of the foregoing clarification and as noted below, we believe that some of the information you requested is now irrelevant in terms of the specific relief that Alpine is requesting. For your easy review, we have excerpted your requests below:

***Requested Information:***

1. *In Alpine Section 25137 Petition, Alpine claims that the FTB's proposed inventory adjustment will result in "gross distortion" of Alpine's tax liability unless the apportionment factors of Alpine Electronics, Inc. of Japan ("AEJ") are taken into account in determining Alpine's tax liability.*
  - a. *What are the amounts of the apportionment factors of AEJ that Alpine contends must be included? From what tax year were they derived? Provide documentation supporting these factors.*

Pursuant to FTB Notice 89-601, the intercompany transaction should be subject to apportionment by the apportionment factor of the income year immediately preceding the income year of the election. Accordingly, the appropriate apportionment factor is that utilized in apportioning Alpine's income to California for the year ended March 31, 1988. Pursuant to supporting documentation produced by the Franchise Tax Board related to an FTB audit for the year ended March 31, 1988, the California apportionment percentage for the Alpine worldwide reporting group was 1.8443%. (Please see the supporting schedule, attached as "Exhibit A".)

March 22, 2002

Mr. Jeffrey I. Margolis

- b. *Does Alpine contend that the apportionment factors of AEJ that must be included in determining Alpine's California tax liability should be applied to Alpine's entire income for the year, or only to the inventory income adjustment in the notice of proposed assessment? If Alpine contends that AEJ's apportionment factors should be applied to Alpine's entire income for the year, please explain why.*

Alpine contends that the worldwide apportionment factors should be applied only to the inventory income adjustment as determined by the FTB's notice of proposed assessment. (See NPA dated December 12, 1997, attached as Exhibit "B".)

2. *Was the inventory at issue in this matter purchased by Alpine from AEJ at its "fair market value"? Please provide supporting documentation for your response.*

We understand that you are requesting this information pursuant to your previous understanding that Alpine was requesting a step up in basis of its beginning inventory pursuant to its 25137 petition. Since the requested factor relief presumes that the intercompany profit is recognized, we believe that this information is no longer relevant to the determination we are seeking.

3. *During the period at issue, did AEJ sell the same type of items that were the subject of the inventory gain adjustment in this matter to unrelated entities? Were the sales of those items at the same price(s) at which they were sold to Alpine? Please provide supporting documentation.*

Please see answer to question #2.

4. *Because Alpine's California tax liability might be distorted if all of AEJ's apportionment factors are taken into account but only a portion of AEJ's sales (those to Alpine) are taken into account, identify the amount of AEJ's total worldwide sales, and the ratio of AEJ's sales to Alpine compared to AEJ's total worldwide sales during the relevant year(s). Supply supporting documentation for these figures.*

Please note that we are requesting that Alpine's worldwide apportionment factors for the year ended March 31, 1988 be taken into account. These factors, as determined by the FTB's examination would have included AEJ's worldwide sales, but would not have included its intercompany sales to Alpine. We understand that you are requesting this sales information to ensure that the utilization of AEJ's apportionment factors are not distortive given that only a portion of AEJ's sales (those to Alpine) are being taken into income through the proposed audit adjustment. Given the fact that we are requesting

March 22, 2002

Mr. Jeffrey I. Margolis

that the worldwide apportionment factors be utilized, we do not believe that information regarding AEJ's worldwide sales are relevant to the requested relief. Nevertheless, Alpine is attempting to locate this information, and we will send it to you if and when it becomes available.

However, information regarding the unitary group's entire worldwide sales and AEJ's sales to Alpine for the year ended March 31, 1988 may be relevant. The unitary group's entire worldwide sales for the year ended March 31, 1988 were \$2,658,967,918. (See FTB schedule attached as Exhibit "A".) (Please note that the sales are reflected on that schedule as 370,474,000,000 yen, which we have converted to U.S. dollars at the rate of 139.33.) The total amount of AEJ's sales to Alpine for the year ended March 31, 1988 were \$21,450,609. (See schedule prepared by Franchise Tax Board, attached as Exhibit "C.")

5. *In Appeal of Yamaha, the SBE permitted Yamaha to use the methodology set forth in FTB Notice 89-601. . . in including the FTB's inventory adjustment into income. Please provide the information that would be necessary to apply the methodology of Notice 89-601 to Alpine's situation. Be certain to include information concerning all deferred intercompany transactions among the members of Alpine's combined unitary group, not just the inventory adjustment raised in the notice of proposed assessment.*

Apart from the inventory-related intercompany profit, we are unaware of any other deferred intercompany transactions among the members of Alpine's combined unitary group. Please note that our understanding is borne out by the adjustment proposed by the FTB in its NPA which proposes no adjustments related to other deferred intercompany transactions.

FTB Notice 89-601 provided that gains or losses from intercompany transactions which cease to be deferred due to a water's edge election, should be subject to apportionment by the apportionment factor of the income year immediately preceding the income year of the election. The apportioned amount is then to be included in income on a pro rata basis over a period of five years. Accordingly, the information necessary to apply this methodology is the California apportionment factor for the worldwide group for the year ended March 31, 1988. We have recalculated the deferred intercompany transaction at issue in this case utilizing Alpine's March 31, 1988 worldwide apportionment factor. The tax effect of the revised total adjustment for the year ended March 31, 1989 would total \$17,460, assuming that the entire adjustment is taken into account in that year. Please refer to our worksheet attached as Exhibit "D".

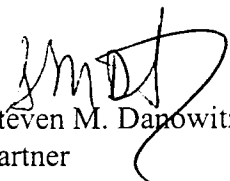
Mr. Jeffrey I. Margolis

March 22, 2002

Additionally, we wish to reiterate the fact that we have requested a hearing pursuant to Cal. Rev. & Tax Code section 25137 before the three-member Franchise Tax Board in the event that our request is not approved by staff.

Thank you for your time and consideration in this matter. Should you have any further questions, please call me at (310) 551-5599.

Sincerely,

  
Steven M. Danowitz  
Partner

Attachments

CORPORATION NAME: ALPINE ELECTRONICS OF AMERICA  
 CORPORATION NUMBER: 0877147  
 COMPLETION OF TAX BASED ON INTRASTATE APPORTIONMENT  
 PERIOD: 12/1/88 TO 12/31/89

SCHEDULE 1  
 PAGE 2 OF 2

## CORPORATIONS WITHIN CALIFORNIA:

	TOTAL	1 ALPINE ELECTRONICS	2 ALPS ELECTRIC	3 XXXXXX XXXXXX	4 XXXXXX XXXXXX	5 XXXXXX XXXXXX
PROPERTY	252,539,000,000	2,743,058,734	4,206,923,872	0	0	0
PAYROLL	34,417,000,000	635,974,711	676,872,246	0	0	0
SALES	370,474,000,000	9,643,420,121	22,040,968,688	0	0	0
PERCENTAGE APPLICABLE						
PROPERTY	2.7412%	1.0819%	1.6593%	0.0000%	0.0000%	0.0000%
PAYROLL	3.8146%	1.8479%	1.9667%	0.0000%	0.0000%	0.0000%
SALES	8.5524%	2.6030%	5.9494%	0.0000%	0.0000%	0.0000%
TOTALS	15.1082%	5.5328%	9.5754%	0.0000%	0.0000%	0.0000%
AVERAGE PERCENTAGE	5.0361%	1.8443%	3.1918%	0.0000%	0.0000%	0.0000%
TOTAL UNITARY BUSINESS INCOME AS REVISED	130,441,285	2,405,728	4,163,424	0	0	0
APPLICABLE ADJUSTMENTS TO CALIFORNIA INCOME: (if any)						
-	0	0	0	0	0	0
-	0	0	0	0	0	0
-	0	0	0	0	0	0
NON-BUSINESS INCOME (OR LOSSES) WHOLLY ATTRIBUTABLE TO CALIFORNIA						
TOTAL CALIFORNIA NON-BUSINESS ITEMS	0	0	0	0	0	0
LESS: INTEREST OFFSET	0	0	0	0	0	0
NET INCOME BEFORE CONTRIBUTION ADJUSTMENT	6,569,152	2,405,728	4,163,424	0	0	0
CONTRIBUTION ADJUSTMENT	0	0	0	0	0	0
NET INCOME AFTER CONTRIBUTION ADJUSTMENT	6,569,152	2,405,728	4,163,424	0	0	0
ADJUSTMENT FOR:						
NET OPERATING LOSS CARRYOVER (if any--Sch. ____)	0	0	0	0	0	0
NET INCOME FOR STATE PURPOSES	6,569,152	2,405,728	4,163,424	0	0	0
TAX RATE	9.300	9.300	9.300	0.000	0.000	0.000
TAX	610,891	223,733	387,198	0	0	0
MINIMUM TAX CORPORATIONS	0	0	0	0	0	0
OTHER TAXES	0	0	0	0	0	0
LESS: OTHER CREDITS	45,222	0	45,222	0	0	0
NET TAX	565,669	223,733	341,976	0	0	0
TAX ON PREFERENCE INCOME/ALTERNATIVE MINIMUM TAX	0	0	0	0	0	0
TOTAL TAX	565,669	223,733	341,976	0	0	0
LESS: PREVIOUSLY ASSESSED	589,414	132,975	454,939	0	0	0
ADDITIONAL TAX DEFERMENT	23,745	90,242	112,956	0	0	0

Ex. A



STATE OF CALIFORNIA  
**FRANCHISE TAX BOARD**  
P.O. BOX 942857  
SACRAMENTO, CA 94257-0021  
TELEPHONE:  
(800) 852-5711

**NOTICE OF  
PROPOSED ASSESSMENT**

**2**

00352294

In accordance with provisions of the Revenue and Taxation Code, notice is hereby given that we propose to assess a deficiency for the income year or taxable year shown below. Details of the proposed assessment are explained below.

**See the reverse side for more information and an explanation of your rights and responsibilities.**

DATE

DECEMBER 12, 1997

0877147

AESOA

ALPINE ELECTRONICS OF AMERICA INC  
19145 GRAMERCY PL  
TORRANCE CA 90501-1128

INCOME YEAR ENDED 03/31/99  
SERIAL NO/D.L.N. 2690401  
AMOUNT \$ 211,150.00  
REV CODE 3636802:RAC:LIL

REVISED NET INCOME PER SCHEDULE I PG 1 OF 4

\$2,273,659.00

DATED 08/06/97

TAX AT 9.3% - MINIMUM

211,750.00

PREVIOUSLY ASSESSED

600.00

TOTAL ADDITIONAL TAX

211,150.00

WE HAVE REVISED NET INCOME BASED ON THE FIELD AUDIT SCHEDULES PROVIDED TO THE TAXPAYER'S REPRESENTATIVE.

THIS CORPORATION MEETS THE REQUIREMENTS OF THE ELECTRONIC FUNDS TRANSFER (EFT) PROGRAM. THEREFORE, PAYMENT MUST BE MADE THROUGH EFT. PAYMENT BY OTHER MEANS WILL RESULT IN A PENALTY OF 10 PERCENT OF THE AMOUNT PAID.

CC: ERNST & YOUNG LLP  
ATTN: MARK D CHAO

CONSENT CASE

Enc.

ALPINE ELECTRONICS OF AMERICA INC.  
I/O PROFIT IN ENDING INVENTORY  
TAX YEAR ENDED 3/88

PN  
6/13/86

INV. FOR DETERMINATION ON I/O PROFIT (1)  
ACJ'S GROSS PROFIT PERCENTAGE, PER ATTACHMENT 2  
I/O PROFIT IN ENDING INVENTORY

ALPINE ELECTRONICS  
OF AMERICA

\$ 21,450,808  
21.8164%  
\$ 4,698,842

ALPINE ELECTRONICS MFG.  
OF AMERICA

28,288,401  
21.8164%  
5,682,813

NOTE:

(1) PER REPRESENTATIVE'S W/P A, PROVIDED IN LETTER DATED 4/18/86.

ATTACHMENT 1

Ex. C



# ALPINE --- EXHIBIT D

## Tax Effect of Using 89-601 Method for Intercompany Inventory Adjustment

Tax Rate   Total Tax   Difference

### PER FRANCHISE TAX BOARD:

Revised Net Income Per NPA - 3/31/89	\$2,273,659	9.3%	\$211,450
Intercompany Inventory Adjustment - Alpine Only	4,636,842		
3/31/89 Apportionment Percentage	46.83%		
	<u>\$2,171,433</u>		
Revised Net Income Prior To Inventory Adjustment	\$ 102,226		

### ALTERNATIVE ONE: Modified 89-601 (Not Pro-rated over 5 years)

Revised Intercompany Inventory Adjustment:			
Intercompany Inventory Adjustment - Alpine Only	4,636,842		
3/31/88 Apportionment Percentage	1.8443%		
Revised Net Income Prior to Inventory Adjustment	\$ 85,517		
Total Revised Net Income 3/31/89	<u>\$ 102,226</u>		
	\$ 187,743	9.3%	\$17,460
			\$193,990

### ALTERNATIVE TWO: 89-601 (Pro-Rated over 5 Years)

Total Intercompany Inventory Adjustment Per Above	85,517		
3/31/89 Related Income if Prorated over 5 years	\$ 17,103		
Revised Net Income Prior to Inventory Adjustment	<u>\$ 102,226</u>		
Total Revised Net Income 3/31/89	\$ 119,329	9.3%	\$11,098
			\$200,353

Ex. D

# EXHIBIT D

**STAFF SUMMARY AND RECOMMENDATION CONCERNING  
THE SECTION 25137 PETITION FILED BY  
ALPINE ELECTRONICS OF AMERICA, INC.**

**Introduction**

California Revenue and Taxation Code section 25120 *et seq.* (the Uniform Division of Income for Tax Purposes Act, "UDITPA") establishes rules for the apportionment and allocation of income of multistate corporate taxpayers that do business both within and without the State of California. Section 25137 allows such taxpayers to request deviations from the standard apportionment rules in situations where those rules do not fairly reflect the extent of the taxpayer's business activity in this State.

The taxpayer in this matter, Alpine Electronics Corporation and its wholly-owned subsidiary, Alpine Manufacturing of America, Inc. (hereafter collectively referred to as "taxpayer" or "Alpine/CA") has requested that it be permitted to deviate from the standard apportionment formula in computing its tax liability for its tax year ending 3/89 (hereafter "the year at issue").

FTB staff recommends that the taxpayer's request be denied. This matter is submitted to the Board pursuant to FTB Resolution 2000-10, in which the Board decided that it would hear "all cases involving the application of Section 25137 in which the taxpayer has requested a hearing before the Board and where the staff recommends that the [Section 25137] petition be denied[.]"

**Facts**

The taxpayer was in the business of selling car and home audio systems, much of which it purchased from its parent company, a Japanese corporation, Alpine Electronics of Japan ("Alpine/JPN").

The taxpayer also is an affiliate of (among others) Alps Electric, Inc. ("Alps"), a hi-tech corporation domiciled in California. Throughout the period here involved, Alpine/CA and Alps were engaged in a unitary business with each other through their affiliates, both foreign and domestic. They were not, however, included in an original combined report filed with the FTB. Instead, Alpine/CA and certain of its affiliates filed on a unitary basis *separate from* the unitary combined report filed on behalf of Alps and certain of its affiliates.

Alpine/CA made a "water's-edge election" pursuant to Revenue and Taxation Code section 25110 for its year ending 3/89 pursuant to which it excluded both the income and the apportionment factors of its foreign parent and affiliates from its combined report. Alps later filed an amended return for that year on which it acknowledged that it was unitary with Alpine/CA, and availed itself of Alpine/CA's water's-edge election.

Neither Alps nor Alpine/CA dispute the fact that they were unitary with each other during the period at issue. However, represented by different counsel, they claim to be unable to access each other's tax data and have separately contested the FTB's redetermination of their tax liabilities for the period at issue.

During the year ending 3/88, both Alpine/CA and Alps "purchased" inventory from their unitary foreign parents for resale in the United States. That inventory remained unsold as of the end of that tax year and was sold during the year at issue *after* the water's-edge election took effect.

Because the inventory had been acquired from members of their own unitary group, the intercompany inventory transactions were ignored by Alpine/CA and Alps in computing their unitary income for the year in which the purchases were made (*i.e.*, no taxable income was reported to California on account of the intercompany sales to Alpine/CA and Alps from their unitary foreign parents in the year ending 3/88). Instead, under what is known as the "elimination and basis transfer method of accounting" for intercompany transactions, the intercompany sales were eliminated (with no intercompany gain being recognized), and the basis of the inventory was carried over (transferred) from the intercompany sellers (the foreign parent companies) to the intercompany purchasers (Alpine/CA and Alps).<sup>1</sup>

Only when Alps and Alpine/CA sold the inventory outside of the unitary group during the year at issue did they realize taxable gain for California tax purposes. At that time, they were required to report their gain, measured by the amount received from sales to unrelated third parties less the carried-over basis of the inventory in their hands.<sup>2</sup>

On their tax returns for the year at issue, however, Alpine/CA and Alps treated the prior year's intercompany inventory transactions *as if they had been taxable transactions* (though they had not been treated as such by them on their prior year's returns), and claimed a stepped-up basis for their inventory (the stepped-up basis being the internal "sales" price at which the inventory was "sold" to them by their foreign parents in the prior year). The FTB audited both Alpine/CA's and Alps' returns for the year at issue and issued notices of proposed assessment (NPAs) that eliminated the basis adjustments claimed by them. With respect to Alpine/CA, this resulted in a proposed tax deficiency of \$211,150.

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<sup>1</sup> Elimination and basis transfer has been a long-accepted method of accounting for intercompany transactions in a combined report and is in accordance with generally accepted accounting principles. "In computing cost of goods sold, intercompany profits are eliminated from beginning and ending inventory." (Accounting Research Bulletin 51, § 6 and International Accounting Standard No. 3, § 12.) The rationale for the elimination and basis transfer method is that there is no net income produced by internal sales. (*Chase Brass & Copper v. FTB* (1977) 70 Cal.App.3d 457, 473; *Appeal of Texaco, Inc.*, 78-SBE-004, Jan. 11, 1978; Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 Journal of Taxation 106 (1975); Keesling and Warren, *The Unitary Concept in the Allocation of Income*, 12 Hastings Law Journal 421, 59-60 (1960).)

<sup>2</sup> Thus, for example (ignoring for the time being the effects of a water's-edge election), if Alpine/JPN had manufactured stereo equipment at a cost of \$100 that it sold in year 1 to Alpine/CA for \$150, and if Alpine/CA then sold that equipment in year 2 to unrelated customers for \$200, then the unitary group would not have had any income from these transactions in year 1 (as the wholly intercompany sales transaction in year 1 would be ignored) and it would have had \$100 of income in year 2 (the gain being the \$200 received from the outside sales less the \$100 basis carried over from Alpine/JPN).

Both Alpine/CA and Alps separately filed protests from the NPAs. Following denial of the Alps protest, Alps filed a timely appeal with the State Board of Equalization (SBE). The FTB auditor assigned to review Alpine/CA's protest was about to affirm the NPA when, on October 23, 2001, the Alpine/CA filed the instant Section 25137 Petition. Action on the Alpine/CA protest was suspended pending consideration of the instant Section 25137 Petition and the Alps appeal.

In January 2003, the SBE decided the *Alps* appeal and upheld the FTB's position that the elimination and basis transfer method was the appropriate method of accounting for intercompany purchases of inventory from a unitary foreign parent. The SBE ruled, therefore, that when Alps' inventory was sold to unrelated third parties in Alps' first water's-edge year (the same 3/89 year as is involved in this matter), Alps was required to compute its gain using the basis carried over from its foreign parent company. Although the SBE's unpublished decision in *Alps* is not precedential, and prior unpublished SBE decisions in this area have reached differing conclusions, a chronology of the SBE's actions on this issue<sup>3</sup> shows how the SBE's position has developed over time, and strongly suggests that the SBE would apply the same reasoning and reach the same result here that it did in *Alps*. The facts in *Alps* involve a similarly situated sister corporation and are essentially identical to those involved herein.

Nevertheless, the taxpayer, in the context of this Section 25137 Petition, has asked this Board to accept the very arguments that were rejected by the SBE in *Alps*. The taxpayer alleges that application of the principles applied by the SBE in *Alps* would cause its apportionment factors to unfairly reflect the extent of the taxpayer's business in California (*i.e.*, that it would engender "distortion").

### **Specific Relief Sought by the Taxpayer**

By its Section 25137 Petition, the taxpayer seeks to revoke, in part, its irrevocable water's-edge election. Essentially, the taxpayer seeks to retain the benefits of that election (in the form of continuing to exclude the income of its foreign affiliates from its worldwide income) while rejecting the correlative burdens (by asking permission to include the apportionment factors of the foreign affiliates in apportioning the 3/89 income adjustment here at issue).

The taxpayer's Section 25137 Petition (at pp. 2-3) states as follows:

If Alpine's beginning inventory that had been purchased from its Japanese parent receives no step-up in basis, the exclusion of the Japanese parent's apportionment

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<sup>3</sup> In two SBE decisions, *Appeal of Yamaha Motor Corp., USA* (Case No. 89002467500) and *Appeal of Pentel of America Ltd.* (Case No. 89002464880), the SBE initially *accepted* the taxpayer's argument that a step-up in basis resulted from untaxed intercompany sales of inventory. On rehearings in those cases, the SBE *withdrew* its previously-issued opinions and replaced them with unpublished one-paragraph letter rulings (dated December 3, 2001) holding that the "previously unrecognized intercompany gains should be apportioned to California using the apportionment factors for the year prior to the water's-edge election and included in income over a five year period" purportedly "adopt[ing] FTB Notice 89-601." (The *inapplicability* of FTB Notice 89-601 is discussed in footnote 4, below.) Two years later, however, the SBE issued unpublished decisions in *Alps* and *Appeal of Canon U.S.A., Inc.* (Case No. 55001), *abandoning* the five-year spread methodology it had applied in *Yamaha* and *Pentel*, and fully *endorsing* the FTB's position that basis carryover must be applied to intercompany inventory sales.

factors would create gross distortion in the taxpayer's taxable income. ... Alpine seeks relief from the resulting gross distortion.

\* \* \*

... Alpine respectfully requests that your Board allow it to disregard the statutory requirements with respect to the exclusion of [Alpine/JPN's] worldwide affiliates apportionment factors and include them in the computation of California taxable income attributable to such income.

Subsequently, in a letter dated March 22, 2002, the taxpayer amended its Petition so that it not only seeks to be able to use its prior year's worldwide apportionment factors in apportioning its 3/89 (water's-edge year's) income, but that it also be allowed to spread out the FTB's income adjustment over a five-year period.<sup>4</sup>

Applying the prior year's worldwide apportionment factors to the income realized in the 3/89 year would reduce the taxpayer's tax liability by approximately 91 per cent, from the \$211,150 deficiency proposed in the NPA to approximately \$17,460 (a \$193,690 decrease).

For the reasons set forth below, the Section 25137 "relief" requested by Alpine/CA is neither available nor appropriate in the circumstances presented.

### **Staff's Response to Taxpayer's Proposal**

The "relief" requested by the taxpayer under Section 25137 would not be an appropriate exercise of this Board's power for at least four distinct reasons.

#### **1. Section 25137 Cannot Be Used to Reduce the Tax Base**

In the recently decided *Appeal of Crisa Corp.*, 2002-SBE-004, June 20, 2002, the SBE explained that "relief under section 25137 is not available to correct alleged distortion in the amount of income to be apportioned" because "section 25137 is a part of UDITPA, which deals only with allocation and apportionment of income, and not with the determination of income itself."

Because the "relief" sought by Alpine/CA in its Petition affects the amount and timing of Alpine/CA's income (by reducing the amount included in Alpine/CA's 3/89 income and spreading the income in dispute over a five-year period) it is beyond the jurisdiction of the FTB to grant such relief under Section 25137. Accordingly, Alpine/CA's request for such relief must be denied.

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<sup>4</sup> Taxpayer claims that FTB Notice 89-601 authorizes its request. FTB Notice 89-601, however, did not authorize the use of the methodology requested by the taxpayer herein. Instead, FTB Notice 89-601 merely advised the public that the FTB intended to issue future *proposed* regulations concerning the effect of a water's-edge election on intercompany gains or losses that had been "deferred." The regulations ultimately adopted (in 2000) are not, by their terms, applicable to the taxpayer's situation because, among other reasons, they apply only to intercompany transactions occurring on or after January 1, 2001. (Code of California Regulations, Regulation 25106.5-1(k).)

## 2. The Taxpayer Has Not Established That the Standard Apportionment Formula Unfairly Represents Its California Business Activities

Even if the relief requested by the taxpayer were limited to apportionment relief (instead of also dealing with the amount and timing of the taxpayer's income), the taxpayer would still not be entitled to relief because it has failed to satisfy its burden of establishing "by clear and convincing evidence that the formula used by the Board reaches an unreasonable result." (*Colgate Palmolive Co. v. FTB* (1992) 10 Cal.App.4<sup>th</sup> 1768, 1786). This burden clearly resides on the taxpayer, which, in the instant situation, has offered nothing more than conclusory allegations of distortion in support of its request. As stated by the SBE:

Section 25137 comes into play only in exceptional circumstances. Section 25137 does not authorize deviation from UDITPA's normal provisions simply because the taxpayer purports to have found a better approach to apportioning business income. In order to insure that the Act is applied as uniformly as possible, the party who seeks to use extraordinary apportionment methods bears the burden of proving that such exceptional circumstances are present. Mere allegations of distortion are insufficient to persuade us that the normal factors should not be used. [Citations omitted.]

(*Appeal of Simcal Chemical Co.*, 86-SBE-170, September 10, 1986; see also *Colgate Palmolive Co.*, *supra*.)

The taxpayer's conclusory allegations of distortion appear to be based upon its theory that the taxable income in question relates more to the year *before* the year the income at issue was earned (the 3/88 year in which the inventory in question was transferred intercompany from Alpine/JPN to Alpine/CA) than to the year at issue (in which the inventory was sold to unrelated third parties). However, the courts and the SBE have rejected the theoretical underpinnings of the taxpayer's position and confirmed that where, as here, income is generated by a sale, it is the factors of the year of the sale that must be used to apportion the sales income.<sup>5</sup>

The taxpayer's position in this case also violates fundamental principles of unitary theory and has been rejected by the courts and the SBE. Under unitary theory, intercompany transactions within the unitary group are ignored. Yet Alpine/CA's claim of distortion is premised upon recognizing an intercompany sale of inventory to increase the basis of its inventory. Alpine/CA's arguments

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<sup>5</sup> For example, in *Tenneco West, Inc. v. FTB* (1991) 234 Cal.App.3d 1510, the court held that installment sale income should be apportioned by the factors of the year in which the income was earned (i.e., the year of sale) rather than the factors of the later years as the installment payments were received, because the factors of the year of sale more closely represented the activities that generated the sales income. Similar principles were applied by the SBE in *Appeal of The Signal Companies, Inc.*, 90-SBE-003, January 24, 1990. In *Signal*, the taxpayer acquired a company, UOP, that had properly accrued certain losses in the fourth quarter of 1975. The FTB claimed that the UOP was not a part of the taxpayer's unitary group at the time the losses were accrued (and hence the taxpayer could not take advantage of the losses), but that even if the companies were unitary at that time, the losses should be attributed to earlier nonunitary periods for apportionment purposes because the transactions *leading up to* the losses occurred in those earlier periods. The SBE rejected the FTB's position, noting that there was "no authority ... either legal or logical" for allocating the losses to earlier nonunitary periods.

that the standard apportionment formula unfairly reflects its California activities must be rejected because they "are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." (*Container Corp. v. FTB* (1983) 463 U.S. 159, 181; see also *Chase Brass and Copper Co. v. FTB* (1977) 70 Cal.App.3d 457, 469.)

### 3. The Taxpayer's Proposed Alternative Apportionment Formula Is Not Reasonable

The taxpayer's proposed apportionment formula also must be rejected because it is not reasonable. (See generally, *Appeal of Robert E. McKee, Inc.*, 83-SBE-249, December 13, 1983 [in order to invoke Section 25137, the taxpayer must show not only that the normal apportionment formula fails to properly reflect the extent of the taxpayer's activity in this state, but also that the proposed alternative apportionment scheme is "reasonable"].)

Here, it would not be reasonable to permit a taxpayer that has voluntarily availed itself of the benefits of a water's-edge election under which it excluded the income of its foreign affiliates from its unitary income computation to unilaterally renege on that agreement and employ an alternative apportionment formula that continues to exclude such income but incorporates the payroll, property and sales of the foreign affiliates in order to dilute its California apportionment factor. Such a formula breaches the taxpayer's water's-edge agreement, and is so fundamentally inconsistent with the structure of the unitary tax system that it cannot be said to be reasonable. Permitting a taxpayer to utilize all of its worldwide factors to apportion only a portion of its worldwide income engenders distortion; it does not eliminate it. Moreover, even if apportionment relief were appropriate, which it is not, the taxpayer's request to spread the income over a five-year period would be and is totally unreasonable since, as was pointed out above, neither UDITPA nor Section 25137 thereof have anything to do with the amount or timing of income recognition.

### 4. Alpine/CA and Its Sister Corporation, Alps, Should Be Treated the Same

As indicated in the statement of facts above, the issues raised by Alpine/CA herein already have been raised by its unitary affiliate, Alps, and rejected by the SBE. Although Alpine/CA raises these issues in a slightly different context (a Section 25137 Petition as opposed to an appeal before the SBE) there is no reason for this Board to depart from the principles applied by the SBE in this situation. These principles should be applied evenhandedly to all similarly-situated taxpayers. Alpine/CA made no showing of any special distortion and is entitled to no special relief. Both Alpine/CA and Alps must accept the benefits *and* the burdens of their water's-edge election. They cannot exclude the incomes of their foreign affiliates from the computation of their California unitary income while at the same time including the payroll, property and sales of those same affiliates in determining their California apportionment factors.

### Conclusion

For the above-stated reasons, staff recommends that the taxpayer's Section 25137 Petition be denied.